DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS: 01-0127; 01-0128
Indiana Corporate Income Tax
For the Years 1996 and 1997

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ISSUES

I. **Applicability of the Throw-Back Rule** – Adjusted Gross Income Tax.

Authority: 15 U.S.C.S. § 381; IC 6-3-2-2; IC 6-3-2-2(e); IC 6-3-2-2(n); IC 6-3-2-2(n)(1); IC 6-8.1-5-1(b); Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992); 45 IAC 3.1-1-53(5); 45 IAC 3.1-1-64.

Taxpayer argues that the Department of Revenue (Department) erred when it determined that the money taxpayer received from the sale of auto parts to its Illinois customer should have been included in the sales factor numerator.

II. **Management Fees and Royalty Payments as Indiana Source Income** – Adjusted Gross Income Tax.

Authority: IC 6-3-2-1; IC 6-3-2-2(a); 45 IAC 3.1-1-38; 45 IAC 3.1-1-38(4); 45 IAC 3.1-1-55; Mobil Oil Corp. v. Dep't of Treasury, 373 N.W.2d 730 (Mich. 1985).

Taxpayer maintains that as the out-of-state parent company, the money it received in the form of management fees and royalties from its Indiana manufacturing subsidiary was not subject to Indiana's adjusted gross income tax.

STATEMENT OF FACTS

Taxpayers are in the business of manufacturing and selling original equipment auto parts. Two separate but related entities are involved in this protest. The first entity is the out-of-state parent company; the second entity is the manufacturing subsidiary which operates a production facility within Indiana.

The Department originally conducted an audit review of taxpayers' 1996 and 1997 business records and tax returns concluding that both taxpayers owed additional corporate income tax. Taxpayer manufacturing subsidiary (located in Indiana) argues that the money received from the sale of its auto parts to an Illinois auto manufacturer should not have been "thrown back" to Indiana. Taxpayer parent company (located in Michigan) argues that money received from

taxpayer manufacturing subsidiary in the form of management fees and royalties was not subject to Indiana's corporate income tax.

Both taxpayers challenged the audit's conclusions and the assessment of additional income tax. They submitted a protest to that effect, an administrative hearing was conducted, and a Letter of Findings (LOF) was issued denying taxpayers' protest. In the belief that the Department's conclusions set out in the LOF were erroneous, taxpayers asked for and were given the opportunity for a rehearing. The rehearing was held, and this Supplemental Letter of Findings (SLOF) results.

DISCUSSION

I. Applicability of the Throw-Back Rule – Adjusted Gross Income Tax.

Taxpayer manufacturing subsidiary argues that the Department erred when it "threw back" to Indiana the Illinois sales. Taxpayer manufacturing subsidiary further argues that the LOF compounded the original error when it failed to determine that the sales were subject to Illinois income tax.

The audit determined – and the LOF agreed – that, for purposes of determining taxpayer's Indiana tax liability, sales of taxpayer's auto parts to Illinois should be thrown back to Indiana because the sales were made within Illinois where taxpayer (the Indiana manufacturing subsidiary) was not subject to that state's income tax.

The audit arrived at this conclusion because taxpayer did not have an Illinois situs, Illinois property, Illinois payroll, or an Illinois nexus. The audit found authority for its decision to throw back the Illinois sales at 45 IAC 3.1-1-53(5) which states that "[i]f the taxpayer is not taxable in the state of the purchaser, the sales is attributed to [Indiana] if the property is shipped from an office, store, warehouse, factory, or other place of storage in the state." These sales are called "throw-back" sales.

The underlying rule is found at IC 6-3-2-2. IC 6-3-2-2(e) provides that "[s]ales of tangible personal property are in this state if . . . (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and . . . (B) the taxpayer is not taxable in the state of the purchaser." IC 6-3-2-2(n) provides that "[f]or purposes of allocation and apportionment of income . . . a taxpayer is taxable in another state if: (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax; or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." Accordingly, in order to properly allocate income to a foreign state, taxpayer must show that one of the taxes listed in IC 6-3-2-2(n)(1) has been levied against him or that the foreign state has the jurisdiction to impose a net income tax regardless of "whether, in fact, the state does or does not." Id.

Therefore, in order to avoid having the Illinois sales receipts thrown back to Indiana, the taxpayer must show that its Illinois activities are such that it was brought within the orbit of the

Illinois tax scheme. In support of the proposition that the sales should be thrown back to Indiana, the audit report noted that the taxpayer did not pay Illinois income tax during 1996 and 1997 and that it had not filed Illinois tax returns during that period. In addition, the audit reported that taxpayer did not maintain an Illinois business location, did not have property within Illinois, and did not have payroll attributable to Illinois.

The fact that taxpayer did not pay Illinois income tax during this period and – in fact – did not even file Illinois returns is useful in resolving the throw-back issue, but it is not determinative. Instead, whether or not Indiana can throw back these sales hinges on whether or not "taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States." 45 IAC 3.1-1-64.

15 U.S.C.S. § 381 (Public Law 86-272) controls those occasions in which a state – such as Illinois – can impose a tax on the net income, derived from sources within that state, received by foreign (out-of-state) taxpayers. 15 U.S.C.S. § 381 sets a minimum standard for the imposition of a state income tax based on the solicitation of interstate sales. Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447, 2453 (1992). 15 U.S.C.S. § 381 prohibits Illinois from imposing its net income tax on taxpayer if taxpayer's only business activity within Illinois is the solicitation of sales. Illinois may not impose its net income tax on income received from an out-of-state's entity's business activities unless those business activities exceed the "mere" solicitation of sales. Conversely, the effect of Indiana's throw-back rule is to revert this sales income back to Indiana – by including the destination state sales in taxpayer's Indiana sales numerator – in those situations where 15 U.S.C.S. § 381 deprives the destination state of the authority to impose a net income tax. 45 IAC 3.1-1-64. In effect, 15 U.S.C.S. § 381 allows Indiana to tax out-of-state business activities, without violating the Commerce Clause and without subjecting taxpayer to double taxation, because Indiana's right to tax those out-of-state activities is derivative of the foreign state's own taxing authority. In every sales transaction, at least one state has the constitutional authority to tax income derived from the sale of tangible personal property; if the state wherein the sale occurred is precluded from doing so by 15 U.S.C.S. § 381, then that income may be "thrown back" to the originating state.

Taxpayer maintains that its Illinois activities during 1996 and 1997 brought it within the realm of the Illinois income tax. Specifically, taxpayer notes that it has multiple employees who "work at the customer facility in Illinois to ensure that all the needs and concerns of the customer are addressed." Taxpayer explains that "[c]ertain of these employees spend 100% of their time at the customer location in Illinois." Taxpayer concludes that its Illinois "activities were not sporadic, not de minimus, and a proper interpretation of Wrigley could not conclude that these activities are protected by PL 86-272.

During the initial audit – conducted during 1999 – the audit reported that taxpayer's controller indicated that a "trouble shooter" traveled to Illinois to examine defective auto parts but that this occurred only sporadically. It is apparent that taxpayer and the audit differ as to the extent of the Indiana employees' involvement in Illinois. The audit found that the employees rarely traveled to Illinois; taxpayer claims that it has Indiana employees who spend 100 percent of their time in Illinois thereby subjecting itself to Illinois income tax.

When a taxpayer challenges a tax assessment, it is up to the taxpayer to demonstrate that the assessment is incorrect. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1(b). Set up against the audit's finding that the employees' Illinois activities were de minimis, taxpayer has submitted the bare assertion that its employees' involvement with its Illinois customer is considerably more extensive. However, taxpayer has provided nothing specific documenting the extent of this involvement during 1996 and 1997.

The Department is unable to conclude that taxpayer has met its "burden of proving that the proposed assessment is wrong . . . ." Id. Although not conclusive on the issue, the Department finds especially telling the fact that taxpayer itself did not conclude that it was subject to Illinois income tax during 1996 and 1997 and, in fact, did not submit Illinois state income tax returns during that period. The Department is unable to depart from its original conclusion as stated in the LOF; "Taxpayer's sporadic inspection of non-conforming [auto] parts 'is sufficiently *de minimis* to avoid loss of the tax immunity conferred by § 381' The inspection of the auto parts did not void the immunity from Illinois income taxes conferred under 15 U.S.C.S. § 381 and Illinois may not tax these particular receipts."

The Department stands by its original decision that the audit was correct in concluding that the income received from Illinois sales should have been thrown back to Indiana.

FINDING

Taxpayer's protest is respectfully denied.

II. Management Fees and Royalty Payments as Indiana Source Income – Adjusted Gross Income Tax.

Taxpayer parent company (Michigan) and taxpayer manufacturing subsidiary (Indiana) entered into an arrangement by which taxpayer manufacturing subsidiary paid money to taxpayer parent company. Taxpayer parent company agreed to provide taxpayer manufacturing subsidiary with "patented proprietary technology," "ancillary technical services," the right to use taxpayer parent company's trade name, and the right to use proprietary "just in time computer technology." (*Hereinafter* "intellectual property") In return, taxpayer manufacturing subsidiary agreed to produce auto parts which met taxpayer parent company's standards for quality of materials, procedures, and manufacturing methods. Taxpayer manufacturing subsidiary agreed to pay taxpayer parent company a five percent royalty fee based on the invoice price of the auto parts.

Taxpayer parent company also agreed to provide management services to taxpayer manufacturing subsidiary. According to the audit report, taxpayer parent company's personnel visited the Indiana facility, provided engineering services, provided research and development services, and provided various management functions. In return, taxpayer manufacturing subsidiary paid taxpayer parent company a "management fee."

The audit review concluded that taxpayer parent company (Michigan) should have been paying Indiana adjusted gross and supplemental net income tax on the royalties and management fees received from taxpayer manufacturing subsidiary (Indiana). Taxpayer disagreed and submitted a protest. The Department's original LOF concluded that the intellectual property had acquired an Indiana "business situs" and that the provision of management services constituted "income from doing business in this state."

Taxpayer parent company continues to disagree stating that the conclusions set out in the LOF were "both factually and technically incorrect." In regards to the management services agreement, taxpayer claims that there is no evidence that taxpayer parent company ever actually performed any services for its Indiana affiliates; taxpayer parent company states that the management services agreement was in place only to cover the *possibility* that such services would be needed by the Indiana affiliates.

IC 6-3-2-1 imposes a tax on the adjusted gross income derived from "sources within Indiana." IC 6-3-2-2(a) states that adjusted gross income derived from sources within Indiana includes "income from doing business in this state." IC 6-3-2-2(a). 45 IAC 3.1-1-38, in interpreting IC 6-3-2-2(a), provides that for apportionment purposes a taxpayer is "doing business" in Indiana if it operates a business enterprise or activity in Indiana including "[r]endering services to customers in the state." 45 IAC 3.1-1-38(4).

Taxpayer parent company appears to be arguing that the money attributable to the parties' management services contract is not subject to Indiana adjusted gross income tax because taxpayer parent company never actually did anything *within* this state to earn this money. However, questions of taxability are not determined by whether or not the parties to an agreement have struck a satisfactory bargain or whether one of the parties ever performed its part of the bargain. In effect, taxpayer manufacturing subsidiary was simply paying for the assurance that *if* it ever needed these services within the state, taxpayer parent company would be prepared to provide them. If taxpayer parent company never performed any of these services but merely stood ready to provide them, then that assurance was the very service that taxpayer parent company was providing to the Indiana entity.

In this case, taxpayer was providing a service to taxpayer manufacturing subsidiary in return for which taxpayer manufacturing subsidiary paid taxpayer parent company a not insubstantial amount of money. Taxpayer manufacturing subsidiary and taxpayer parent company entered into an agreement by which taxpayer parent company would provide taxpayer manufacturing subsidiary certain "management services." Questions over who got the best of the bargain or whether taxpayer manufacturing subsidiary received $1 worth of services or $1,000,000 worth of services are irrelevant; the fact remains that taxpayer parent company received money from an Indiana entity to provide a "service" to that Indiana entity.

In addition, taxpayer continues to assert that the royalties paid for the use of the intellectual property is not subject to adjusted gross income tax. According to taxpayer, the intellectual property never acquired an Indiana situs. Taxpayer contends that only Michigan can include the royalty income within that state's receipts factor. According to taxpayer, the royalty income is "sourced to Michigan under the definition of 'gross receipt.'" However, it should be noted that

Michigan exempts royalty income from taxation; the Michigan Single Business Tax Act taxes the one which pays royalties, not the one which receives them. *See* Mobil Oil Corp. v. Dep't of Treasury, 373 N.W.2d 730, 742-43 (Mich. 1985).

In order for Indiana to tax the money received from an intangible – such as taxpayer parent company's patents and trademarks – the intangible must have acquired a "business situs" within the state. 45 IAC 3.1-1-55 states that "[t]he situs of intangible personal property is the commercial domicile of the taxpayer . . . unless the property has acquired a 'business situs' elsewhere. 'Business situs' is the place at which the intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property."

Taxpayer parent company's commercial domicile is in Michigan. However, by virtue of the royalty agreement between taxpayer parent company and taxpayer manufacturing subsidiary, the intellectual property has acquired a "business situs" within Indiana. Taxpayer parent company licensed taxpayer manufacturing subsidiary to make use of the trademarks and patents within Indiana in conjunction with the manufacture and sale of taxpayer manufacturing subsidiary's auto parts. The "substantial use or value" which attaches to this intellectual property derives from the licensee's right to exploit that intellectual property. The entity which exploits the intellectual property is taxpayer manufacturing subsidiary because it is the licensee in the royalty agreement. As the licensee, taxpayer manufacturing subsidiary exploits that intellectual property within Indiana. The royalties are simply the economic benefits which derive from the ability of taxpayer manufacturing subsidiary to exploit the intellectual property; those economic benefits (the royalties) flow from taxpayer manufacturing subsidiary to taxpayer parent company but these benefits are attributable to the Indiana licensee's activities. Under 45 IAC 3.1-1-55, the trademarks have acquired an Indiana business situs; under IC 6-3-2-2(a), the royalty payments are subject to Indiana's adjusted gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

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